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CURRENCIES AND CREDIT MARKETS

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"The effects of these capital imports are clear: not only were adjustments prevented, but the pulse of . . . business became dependent on the rate of flow of foreign funds; with foreign banks financing a considerable part of investment and current spending . . . the policy of the central bank was checkmated; the consumption boom was propelled; and of course, a financial situation was created that was in constant danger of collapse on comparatively small provocation. . . . the foreign credits camouflaged "inflation" by producing its results under the surface of an apparently very "sound" monetary system."

Joseph Schumpeter, Business Cycles

HIGHLIGHTS

Surveying world inflation trends, an anomaly seems apparent: the weaker the economy the higher the inflation. That's a strong hint that inflation problems do not find their customary cause in overheated demand.

Large external deficits and a reliance on capital inflows on the part of the "high yield" countries has caused currencies to play a large role in that anomaly.

The stabilization of domestic prices through currency overvaluation in the past has carried a price. It benefits the consumer at the expense of the producer and boosts consumption at the expense of investment.

If a currency is overvalued it should first show up in the falling profits of the country's manufacturing sector. Sweeping drops in business profits indicate that the "high deficit" countries lack international competitiveness. Obviously, the currencies of these countries must be overvalued.

Judging purely from the objective fundamental facts, we would say that the dollar is ripe for another major slide - at least against the D-Mark and the European currencies.

The policy dilemma for some of the deficit nations is becoming acute. Weakening economies prompt a monetary easing yet the prospect of a dropping currency makes central banks hesitate. Canada and Australia, particularly, are textbook cases.

America's current inflation uptrend is deeply embedded. It finds deep roots within two long-term trends on the supply-side of the economy: continued abysmal investment/productivity performance, and unfavourable demographics in the labour market.

Most observers have yet to realize that lower a U.S. economic growth potential in the 2-2.5% range (or lower!) is not merely a cyclical matter but a function of a deeper secular weakening in available resources.

WORLD BOND MARKETS IN TURMOIL

Inflation fears have beset global financial markets. Within just a few months, recession worries have been eclipsed by this new fear for five reasons: Firstly, the continuing horror stories over future inflation in Germany due to the uncertainties of a fast-approaching East-West German economic and currency unification (Gemu); second, the perception that the U.S. economy is now strengthening rather than weakening; third, recent discouraging inflation data, particularly in the United States and Britain; fourth, more worrying news about accelerating inflation in Japan further compounded by a weak yen; and finally, a new upturn in non-oil commodity prices.

Taken together, these factors seem to present quite a convincing picture. Yet, we have to realize that the underlying economic, monetary and financial conditions in each of the major countries differ quite markedly.

The Averages Hide the Extremes. Looking at the global economy as a whole, countries can be divided into three groups: first, recession candidates including among them the countries of the United States, Britain, Canada, Australia and some Scandinavian states: second, countries with continuing strong growth - Continental Europe mainly qualifies here; and third, countries where growth is still high, though slowing significantly. This last group is mainly comprised of Japan and the Far Eastern countries.

As far as the world economy is concerned, two observations can be made presently: the economic cycles of different countries are getting out of "sync", and, on average, economic growth is distinctly slowing. These two trends should prevent price pressure on resources, yet, inflation has clearly accelerated. The following two tables show the divergent developments in inflation and economic growth among various countries. At first glance, an anomaly seems to be apparent: the weaker the economy the higher the inflation.

COMPARISON: CONSUMER PRICES (% Changes at annual rates)			INDUSTRIAL PRODUCTION (% Changes at annual rates)		
Country	**3 Mos.**	**Yr.**	**Country**	**3 Mos.**	**Yr.**
United States	8.5	5.2	United States	-0.4	1.0
Britain	7.3	8.1	Britain	-4.9	0.3
Australia	7.7	7.8	Australia	-8.5	0.1
Canada	4.2	5.4	Canada	-0.5	-0.2
Germany	2.8	2.3	Germany	9.6	4.4
France	2.8	3.4	France	0.7	2.2
Japan	-0.5	3.6	Japan	2.8	3.4

Inflation and Growth Somewhat Unlinked. The consensus view is that inflation rates will converge this year. Prices in Japan and in Germany particularly are supposed to rise, while those in the Anglo-Saxon countries are supposed to fall under the weight of slowing economies. As such, all these inflation rates are expected to meet in the 4% range. Many economists interpret these expectations as bullish for the U.S. dollar and bearish for the D-Mark.

They are mistaken. In the case of the U.S., they overestimate the underlying economic strength and underestimate its underlying inflationary bias. In theory, there is only one thing that might be able to save the "recession candidates" from recession: an export boom, with exports compensating for faltering domestic demand . . . but, that's nowhere in sight.

Given the boom conditions of Europe and the Far East, one might think that such an export boom should be feasible at least for America. But the hard fact is that U.S. merchandise exports have stagnated for a full year. Improvements in the trade balance have resulted exclusively from slower imports which are mainly a reflection of weak domestic demand. It does not seem that domestic producers are winning back home market shares. That would be essential to improve GNP growth.

Why is it that these countries are unable to more profitably take advantage of the boom in Europe and the Far East? Sweeping drops in business profits indicate that they lack international competitiveness. Obviously, the currencies of these countries are overvalued.

Currencies and Capital Flows Obscure the View. The one thing that is still comforting investors in these countries is that an economic slowdown, if nothing else, will at least reduce inflation. That may be true up to a point, but on the whole, we think these hopes will be rather disappointed. There is more inflation embedded in the economies of these countries than meets the naked eye. The fact is that these countries with large trade and current account deficits have, quite literally, borrowed lower inflation from abroad. If it weren't for large trade deficits, huge capital inflows, and overvalued currencies, inflation in these countries would have been far worse.

Large trade deficits and overvalued currencies don't cure inflation. They only affect the symptoms and not the cause. The true inflation tendency will remain suppressed as long as these two conditions prevail. When the trade deficits finally shrink and the currencies begin to fall, the true underlying inflation will surface. In a way, one might say that the "borrowed" inflation stability has to be paid back.

POLICY CLASH: BALANCING CURRENCIES AND ECONOMIES.

All the major deficit countries now face a triple dilemma: weak economies, relatively high interest rates and the threat that any monetary easing might trigger a sharp fall in their currency which in turn implies more inflation. These developments would also surely unnerve financial markets. Each of the respective central banks are therefore more hesitant than usual to ease. Canada and Australia, particularly, are textbook cases of this situation.

Australia has already recorded one quarter of negative growth. As short-term interest rates have dropped 350 basis points or so, the Australia dollar has fallen from US $0.79 to $0.75 even though the currency has already seen a sudden decline earlier in 1989 from the level of US $0.89. In the meantime, long-term interest rates moved up from 12.8% to 13.8%.

Canada is a more timely case-study since the Canadian dollar (currently at U.S. $0.857) is still hovering near the decade-high of $0.8641 against the U.S. dollar. In the meantime, the economy has begun to decelerate. Canada has engorged itself with capital inflows in recent years to the

point where 38% of its bond market is held by outside investors. Last year alone, foreign investors bought CDN. $23.9 billion worth of marketable stocks and fixed-income securities.

In January of this year, the Bank of Canada learned something of the predicament that faces all of the deficit countries. On the evidence of a slowing economy, the Bank eased slightly by allowing short-term interest rates to drop from 12.2% to 11.9% and inadvertently triggered a sharp drop in the Canadian dollar from US $0.862 to as low as $0.8275. The Bank was quickly forced to tighten again in order to cushion the fall of the currency. The outcome of the saga was that short-term interest rates ended up rising to as high as 13.55% and the bond market saw a serious disaster. During this period, domestic long-term interest rates rose faster than short-term interest rates jumping from 9.6% to 11.6%.

THE U.S. DOLLAR

In the United States, for the time being, no one speaks of a monetary easing any more. That mood swing has stabilized the dollar. But looking at the different demand components, there is simply no basis for a sustainable, however modest, recovery in the economy. Manufacturing weakness is gradually but relentlessly spreading to the service sector.

According to market folklore, Chairman Greenspan has master-minded the soft landing of the U.S. economy by the timely easing in mid-1989. Reacting to a flow of soggy economic data and rising fears of recession the Fed had lowered its Fed funds rate from 9-7/8% to 9% during June and July and further to 8-1/4% in October-November.

As matter of fact, the weakening of the economy did not materialize in either the second or in the third quarter. Real GNP grew 3.7% in the first quarter, 2.5% in the second and 3.0% in the third. For the markets, this was confirming evidence of the Fed's fine-tuning skills as well as evidence of the U.S. economy's great responsiveness to any monetary easing. On closer examination, this experience proved rather the exact opposite: namely, the shortcomings of fine-tuning.

What was the inflation picture when the Fed eased to rapidly? Did it look so good? The consumer price index (CPI) rose at an annualized rate of 5.2% in the second quarter of 1989, after having risen 4.8% during the first quarter. Similarly, the producer price index (PPI) increased 6% and 5.1%, respectively. That was well above the rates of a year earlier.

If the Fed was in a hurry to ease, the credit markets - believing that inflation had been quelled - were in an even greater hurry. During May and June, markets were wildly bullish about both the dollar and U.S. bonds. Foreign money poured into dollar-bonds, attracted by the promise of certain capital gains. While the dollar soared from DM 1.85 to DM 2.04, long-term U.S. government bond yields plummeted from 9.25% to a little below 8%. Many, if not most commentators, predicted a dollar/DM rate of DM 2.40 and that U.S. long-term bond yields would fall to 7% and lower.

It was nothing but a brief speculative bubble based on grossly fallacious forecasts and equally fallacious theories. The main underlying theory had been that a recession would be bullish for the bond market and the dollar as it would improve the trade balance and attract foreign capital

in search of capital gains as interest rates fell.

As it turned out, the economic data had given false signals. The soggy economic data dissolved, not really through the Fed's fine-tuning, but through subsequent, considerable upward revisions. Included among these was the revision of second-quarter real GNP growth from 1.7% to 2.5%. Memory loss, however, led to the rosy notion that stable growth was achieved through the magic touch of the Fed's deft monetary skills.

While logic would say that this experience should have undermined confidence in the Fed's fine-tuning abilities, market adulation actually strengthened, paradoxically. At the same time, the myth that the U.S. economy is virtually recession-proof and that any threatening recession could be prevented by promptly cutting interest rates was further etched into legend.

For our part, we draw three lessons from this episode: first, of course, it is further proof that the high-riding confidence in the Fed's (and the market's) ability to fine-tune the economy is utterly misplaced; second, that while the Fed is undoubtedly concerned about inflation, it has betrayed a tendency to ease significantly at the first evidence of a weakening economy . . . in other words, fighting inflation only has priority as long as a recession appears improbable; and third, that there is a remarkable complacency about inflation in the United States at the current 5-6% range.

PROSPECTS FOR THE U.S. ECONOMY

The truth be known, there is "devil-may-care" complacency on just about everything: the re-accelerating budget deficit, the trade deficit, the record high debt-levels, a still-mushrooming S&L crisis, snow-balling default rates, and - last but not least - the fate of the economy. Some economists bravely assert that the U.S. may never see a recession again.

Not so long ago, some 60% of forecasters surveyed by the National Association of Business Economists (NABE) answered that they didn't expect a recession during the next three years. Sustained growth has led people to believe it can continue indefinitely. Recent experience begets simple extrapolation, while history is ignored.

For 1990, the NABE consensus forecast is for 1.75 - 2% real GNP growth and for inflation to decline to 4-4.5%. The general hope is that a temporary period of economic growth at this rate - supposedly well below potential - will be sufficient to relieve supply tensions and to eventually reduce inflation to below 4%. It seems, at least initially, that markets have embraced these forecasts.

What can go wrong? The first thing that has already gone terribly wrong is inflation. First-quarter consumer price inflation was at an annualized rate of 8.5%, and secondly, though Fed policy is on hold, long-term interest rates are rising. After declining through 8% late last year, government long-rates broke above 9%. Another element that challenges the consensus view is that first quarter GNP growth was expected to be stronger on the basis of employment growth figures. The preliminary GNP estimate for the quarter, if only slightly higher, came in at 2.1%.

THE DEEP ROOTS OF U.S. INFLATION

Most shocking - and for many also most puzzling - is the fact that inflation persists, and, in fact, has sharply accelerated. That flies flat in the face of the general presumption that lower economic growth would promptly slow price increases. The immediate conclusion, therefore, has been that the economy must be stronger than generally thought.

The presumed clear-cut connection between weakening demand and inflation is false. The obvious answer lies on the cost side of the economy, and not on the demand side. There, the first thing to take note of is a steady rise in hourly compensation from 3.7% in 1987 to 5.5% in the year ending in the first quarter of 1990 (the highest rate since the 12-months ended March 1984). Further aggravating rising employment costs is that as output softened, productivity weakened along with it. As a result, unit labour costs have soared from 2.6% in 1987, to 4.6% in 1989 as a whole, and 6.7% in the fourth quarter alone.

What these figures tell us is that America's uptrend in inflation is much more deeply embedded than most people think. More precisely, it is embedded within two long-term trends on the supply side of the economy. One is an old trend and the other is a new one. The old one is a continued abysmal investment and productivity performance. The new one is the demographic underpinnings of a tightening labour market.

A New Problem: Demographics. Due to strong population and work force growth, and sharply rising participation of women, America has had an abundant labour supply in the past. For 30 years this supply has had two beneficial effects. Ample labour supply boosted GNP growth (via employment) and kept a lid on wages. During the seven years of the recovery since late 1982, real GNP grew an annual average rate of 4.3%. That was achieved with a mix of 3% employment growth and 1.3% productivity growth . . . in other words, employment was the main source of growth.

Now, however, the labour force is moving from a period of rapid expansion to much slower growth. Between 1976 and 1986, the number of workers aged 20-34 in the United States grew by 11 million. In contrast, between 1986 and 1996, the number of workers in their twenties will decline by 5 million. The Labour Department projects work-force growth of an average 1.3% for the 1990s.

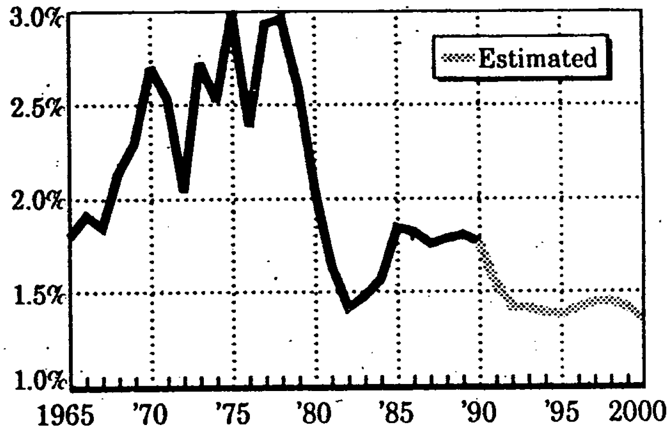
That brings us back to question the Fed's concept that inflation can be cured by limiting current real growth to 1.75-2.0% for a short period. The suspect idea here is the notion that slower growth will create sufficient slack in the labour and product markets to reduce inflation. That's a crucial assumption. Compared with the growth rates of the past recovery, this target looks very modest, but it's anything but modest if one measures potential future employment and productivity growth.

Given the prospect of future labour force growth of 1.3%, any additional economic growth would consequently have to be contingent on productivity growth . . . that is, increases in output per person. How much could productivity growth possibly add over the long run? In 1989, productivity growth was 0.9%, and, as already mentioned, averaged 1.3% in the 1980s.

Retarded Productivity Growth. For unexplained reasons, many American forecasters assume that productivity growth will accelerate again. We don't see the slightest basis for this assumption. True, productivity growth has improved since the 1970s when it was practically nil. But it's absolutely incorrect to regard this improvement as a new trend. The obvious fact is that most of the productivity improvement in the 1980s was attributable to rising capacity utilization of existing capacities, not to increased new investment. Aside from the effects of the business cycle, there was probably no progress at all.

Labor Force Growth Slows

Annual growth; three-year moving average in percent



Sources: Bureau of Labor Statistics and NPA Data Services Inc.

Wall Street Journal

There is, after all, a compelling reason for this negative assessment on future productivity growth. It lies in the abysmal performance of U.S. savings and investment during the 1980s. Given that there has been practically zero net investment in manufacturing over the past ten years - which is the wellspring of productivity growth - it's hard to see how the underlying productivity trend could really have improved.

SPLIT INFLATION, SPLIT ECONOMY

Most observers have yet to realize that, given the poor savings and investment ratios, the U.S. economy is heading for a decline that is neither cyclical nor temporary. It is secular. This decline in potential growth will certainly have many adverse implications. Low growth will boost the budget deficit. Most importantly, there is a vital relationship between inflation and productivity. Increased productivity is the only way to absorb higher wages without driving up prices. In short, America's inflation bias is worsening.

That explanation also sheds light on the question of why the slowing of the U.S. economy so far has blatantly failed to cool inflation. If 2% growth is barely within today's capacity limits, it essentially fails to create any economic slack. Rather, it keeps the economy overheated. The most obvious point in this respect is the tight labour market condition.

Nevertheless, American inflation optimists take comfort from the fact that inflation is not spread evenly. While inflation may be rampant in the service sector, they point to subdued pressures in manufactured goods. Their favourite evidence is the index of materials prices which is up only 2% year-over-year, down from almost a 7% rate a year ago. For many, materials prices represent the true underlying trend.

A recent article in Business Week (April 30th), under the heading *Inflation's Split Personality,* addressed this dichotomy in inflation. The article makes an important point about the cause of this divergence in the price structure that we must emphatically dispute. Their point leads to the wrongest of conclusions. To quote them: "*Prices for manufactured goods, subdued by the Federal Reserve's tight money, grow gently at a 3.5% annual rate*". In other words, it's all to the credit of the Fed. But then, what is the mysterious reason that service-sector prices seem impervious to the Fed's dampening measures? The comforting conclusion is that, sooner or later, service prices will also succumb to the Fed's tight-fisted policy.

In reality, there is nothing mysterious about this inflation disparity in the United States and all the other deficit countries. The basic point is that under a system of flexible exchange rates, a monetary tightening - through the medium of "excess" capital flows and a higher exchange rate - impacts different sectors of the economy very differently.

Every current-account deficit has to be financed by capital inflows. In recent years, it became a common feature world-wide that countries with large deficits and high interest rates attracted "excessive" capital inflows that drove their currencies to artificially high levels. Smaller inflows would have been sufficient to finance the deficits at a constant exchange rate. Perversely, the effect was that deficit countries ended up with the strongest currencies while surplus countries were characterized by weak currencies.

THE CUTTING EDGE: THE EXCHANGE RATE

A strong and appreciating currency has three immediate beneficial effects that everybody loves: first, it moderates inflation by diverting domestic demand abroad and lowering the cost of imported goods; second, the capital inflows dampen pressure for higher interest rates; and third, they make assets denominated in that currency more attractive to foreign investors. For good reasons, currencies have become the pace setters for the financial markets; a strong currency generally buoying markets while a weak currency generally depresses them. Putting it more bluntly, one could say that the deficit countries have artificially low inflation, artificially low interest rates and artificially high asset prices.

The trouble with the positive price effects of a strong currency is that they are not spread evenly over the whole economy. The cutting edge dividing the economy is price competition from foreign suppliers. Broadly speaking, most goods are exposed to foreign competition while most services and construction activities are not. As a result, inflation is split with high inflation in the services sector and low inflation in the goods sector.

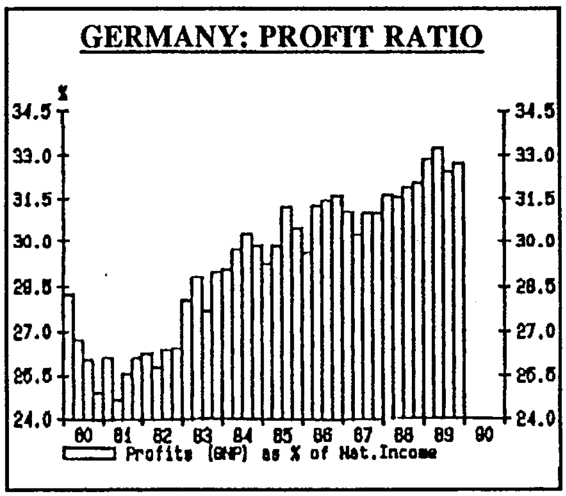
It's not only the price system that is split by an overvalued currency. It splits the whole economy: goods versus services and producers versus consumers. The basic point to see is that an overvalued currency squeezes only one sector of the economy: the manufacturing sector. Indeed, rises in the exchange rate have a much stronger impact on the profitability of the corporate sector than do increases in interest rates.

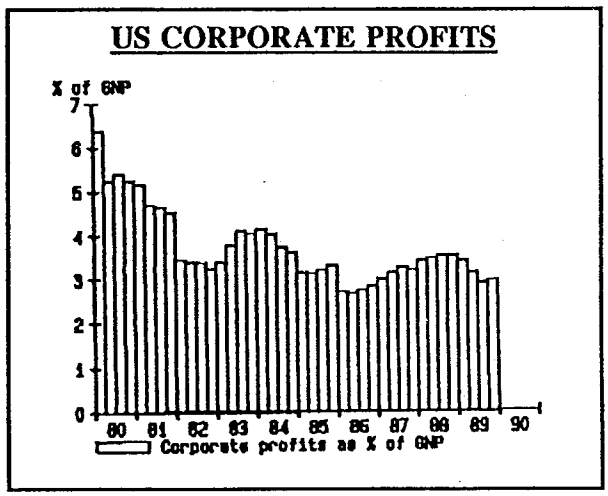
Conversely, strong currencies do not squeeze the consumer at all, except to the extent that unemployment results over the longer-term. Until that point arrives, the consumer benefits greatly

in two ways: first, with an overvalued currency, the consumer can buy more foreign goods. And in the process, low import prices help to keep a price-lid on domestically-produced goods. The second major beneficial effect for the consumer arises in the financial arena. Disproportionately large capital inflows have the effect of buoying the bond, stock, and real estate markets of the deficit countries and contribute corresponding wealth effects.

To sum up, an overvalued currency serves the consumer at the expense of manufacturing and boosts consumption at the expense of domestic investment. That is precisely what we see in the United States as well as the other countries with persistently large external deficits including Australia, Britain and Canada. In all of these nations, consumption overexpands relative to investment in general and manufacturing investment in specific.

In the United States, business profits and manufacturing investment are at their lowest ever as a share of GNP. In other deficit countries, the development is similar. To quote Keynes on this subject: "*But cheapness which means the ruin of the producer is one of the greatest economic disasters that can occur.*"





THE DEUTSCHEMARK

Currencies are always subject to two different sets of influences: domestic on the one hand, and external on the other. Judging purely from the objective fundamental facts, we would say that the dollar is ripe for another major slide - at least against the D-Mark and the European currencies. U.S. inflation is twice as high as that of Germany, while its current real GNP growth is half as high. Meanwhile, Germany has a huge current-account surplus and the United States a huge deficit. Yet, short and long-term interest rates of the two countries are practically at par.

What then, other than sentiment, is supporting the dollar? For the time being, there are apparently three influences:

1. Concerns over the inflationary impact of East-West German currency unification;
2. The yen's protracted slide mainly caused by a prolonged domestic monetary

overexpansion;

3. A highly positive perception of the monetary stance of the Federal Reserve.

Fears of an uncontrolled rise in German inflation and government borrowing in the wake of German monetary unification have halted the rise of the D-mark and triggered a plunge in bond prices, as ten-year yields soared to highs of 9%. Inflation concerns are heightened by the booming economy, capacity pressures and difficult wage negotiations. Expectation of downward pressure on the D-mark may be a major factor currently boosting the yield premium demanded by foreign Bund investors.

Interestingly, the reaction of foreign and domestic investors has been diametrically different. While foreign investors unloaded German bonds in sheer panic, German investors seized the opportunity to lock in such high yields and bought as never before. Their net purchases of DM 30 billion in the first two months of 1990 compares with total net purchases of DM 47.2 billion for the whole of 1989. Obviously, German investors have no doubt about the determination of the Bundesbank to fight inflation in the future just as relentlessly as in the past. And for currency markets, the future action of the Bundesbank is also the key question.

Credibility of the Bundesbank. As explained in the last letter, these stories about the Bundesbank losing control are misplaced. Actually, these stories are ridiculous. There can be no question that the Bundesbank would tighten immediately if there is any justification. At the moment, though, there isn't any need to tighten.

One has to go back more than two decades to find a combination of fast economic growth (4%) and low inflation (CPI 2.3%) as desirable as today in Germany. Maybe it's incomprehensible for some people that a booming economy can have such low inflation. The important point to see is that it is not monetary policy alone that accounts for this extraordinary performance. Further key determinants were stable unit labour costs, and a drastic turn-around in import prices since mid-1989. After a rise of 7.5%, import prices have since fallen 2.8%. During the last three years as a whole, unit labour costs in the economy increased only 2% (as compared to 10% in the United States).

Subdued labour costs have been the result of relatively low wage growth and strong productivity gains. Surging profits led to surging capital spending which in turn assured continuing productivity growth. Business profits as a share of GNP have been restored to the lofty levels of the 1960s. In this respect, the difference of the growth pattern of Germany when compared to that of the United States (overconsumption, under-investment and low profits) is fundamental. These differences don't necessarily show up in the GNP totals, yet they are of over-riding importance for economic growth and inflation over the long run.

In the last analysis, it is these general observations about the dynamics of high profitability and high capital spending that makes us basically optimistic for German markets and the D-mark and pessimistic about the currencies and markets of the United States, Britain, Canada and Australia. The crucial test of every economic policy is its impact on capital formation and profitability, and in this respect, the verdict on the United States and the other deficit countries is devastating.

No doubt, some pressure on wage costs and profit margins will develop as the year progresses. For Germany, that likely means that CPI inflation will be on a modestly rising trend in the second half of the year. But any weakness in the D-mark or any sign of accelerating inflation would trigger a monetary tightening. In this situation, in fact, the Bundesbank has one great advantage over the Fed and other central banks. In Germany, there is no policy conflict because the economy is booming. For the same reason, the public would more readily accept any tightening if it were necessary.

Contrast this enviable situation in Germany with the imbroglio that faces the authorities in the deficit countries with their near-stagnant economies, high inflation rates and vulnerable currencies. Dreadful policy conflicts are in the offing.

In the last letter we said that the key question for currency markets over the next two or three months is the trend of the U.S. economy. If it rebounds with tighter money, the dollar will strengthen. But if it continues to weaken, implying easier money, the dollar will suffer a major slide with the Canadian and Australian dollars close in its wake.

While many commentators are once again conjuring up the "soft landing" of the U.S. economy, we see nothing but trivial up and downs. Clearly, none of the fundamentals that support economic growth has changed for the better. As already pointed out in the last letter, there are horrible contradictions and distortions in the recent economic data. Here's a latest example. It concerns consumption which is supposed to be the backbone of economic growth.

On Monday, April 30, the Wall Street Journal in a comment on first quarter GNP growth, wrote: *"Consumer spending picked up considerably in the first quarter, growing $16.4 billion compared with a $3.6 billion rise in the fourth quarter . ."* One day later, Tuesday, May 1, the same Wall Street Journal commented on consumer spending for March: *"Adjusted for inflation, March personal spending dropped by 0.2% after increasing 0.2% in February and remaining unchanged in January."* Both reports, of course, came from the same source: the Commerce Department.

CONCLUSIONS

The U.S. economy is teetering on the edge of recession. Once the markets come to realize this, the dollar will suffer its next major slide. The past actions of the Fed have clearly shown its bias. Everyone knows that the Fed will be unable to maintain its restrictive policy stance in that situation. What makes the U.S. dollar particularly vulnerable, is the fact that the German and European economy is booming. Since that reality precludes any possibility of a European monetary easing, U.S. monetary policy is really between a rock and a hard place.

A recession will certainly raise hopes for declining inflation and lower (perhaps sharply lower) U.S. interest rates. Yet, it's becoming more doubtful that the bond market will react favourably . . . after all, the fundamentals are truly awful. As tax receipts begin to fall in a slowing economy and the Savings and Loans bail-out requires massive funding, the budget deficit will balloon.

High interest rates in Germany and Japan are squeezing the U.S. and the other deficit countries from the outside. A tumbling dollar will scare the U.S. financial markets and further spike

inflation fears. And, today's type of inflation will prove more stubborn than is generally expected. All these factors dim the outlook for the bond market.

Given this extremely adverse environment, the Fed essentially has no room to ease. Yet, faced with a sinking economy, it will have no choice but to do so and thus risk a plummeting dollar. America faces economic, financial and monetary problems of a type and severity that have never been experienced before. Too much of the past economic achievements were simply borrowed. The bills are now coming due.

Japan's yen and financial markets have stabilized, but the inordinate excesses of the past (see our related comments of the past two letters) and the continued double-digit money expansion make these markets accident-prone.

There is no question that Continental Europe is in the best shape by far of all the world economies. It isn't an exaggeration to say that Europe is experiencing a renaissance. While the sensational opening of the East may be capturing today's headlines, the hard groundwork for this optimistic outlook has really been laid over the past years. Restraint in government spending, wages and consumption have paved the way for rising profits and surging capital spending, those being the drastically improved structural features of Continental Europe. While the Anglo-Saxon countries trumpeted and preached supply-side rhetoric, it was only Continental Europe that put these policies into practice.

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